

Internal Revenue Service
memorandum

CC:TL-N-6119-90

Br4:WHBaumer

date: MAY 0 4 1990

to: District Counsel, Buffalo
Attn: Gary P. Bluestein

from: Assistant Chief Counsel (Tax Litigation)

subject: Request for Tax Litigation Advice
[REDACTED]
[REDACTED]

This is in reply to your request for tax litigation advice concerning whether or not payments made by [REDACTED] to his wife pursuant to a separation agreement constitute alimony. You indicate that although the case is a whipsaw case, the court will presumably require the Service to take a position.

ISSUES

(1) Whether the initial payment of \$ [REDACTED] which is labeled a property settlement payment, satisfies the non-alimony designation test under I.R.C. § 71(b)(1)(B).

(2) Whether the initial payment of \$ [REDACTED] satisfies the test of being contingent upon death of the payee spouse under I.R.C. § 71(b)(1)(D).

CONCLUSIONS

(1) Designation of a payment as part of a property settlement does not alter the character of the payment as alimony for federal tax purposes unless the agreement specifically provides that the payment is nondeductible by the payor spouse and excludible from gross income by the payee spouse. The agreement here fails to contain such language.

(2) An initial payment will not qualify as an alimony payment unless it can be shown either under the agreement or under local law that the payment will cease at the payee's death. Since most jurisdictions, like New York, terminate support payments upon death of the payee spouse by operation of law, the determination of this issue depends upon whether the initial payment of \$ [REDACTED] is alimony under state law. In this case, New York law recognizes the initial payment as a distributive award to effectuate the division of property.

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FACTS

On [REDACTED], [REDACTED] entered into a separation agreement. Paragraph 3 of the agreement is labeled property distribution. Under paragraph 3(b), [REDACTED] is obligated to pay \$[REDACTED] for the purpose of enabling [REDACTED] to secure a replacement automobile. Under paragraph 3(g), [REDACTED] is obligated to pay [REDACTED], on signing of the separation agreement, \$[REDACTED] which sum shall constitute her sole and separate property.

Paragraph 4 of the separation agreement is labeled maintenance. Under paragraph 4(a), [REDACTED] is obligated to pay [REDACTED] \$[REDACTED] per year commencing on [REDACTED], and ending on [REDACTED]. [REDACTED] shall have no further obligation to pay maintenance to [REDACTED] following [REDACTED], except for arrears, if any. Paragraph 4(c) provides that the maintenance obligations of [REDACTED], as set forth in paragraph 4(a), shall terminate upon (1) death of [REDACTED] or (2) death of [REDACTED].

Both [REDACTED] and [REDACTED] were audited and two statutory notices were issued. The cases have been consolidated for trial on the [REDACTED] trial calendar. [REDACTED] did not include any portion of the \$[REDACTED] payment on her tax return based on advice from her counsel that the payments represented a property settlement. [REDACTED] claims that the \$[REDACTED] payment is not contingent upon the death of the payee spouse as required by I.R.C. § 71(b)(1)(D). Under the separation agreement, only payments under paragraph 4(a), dealing with maintenance, are contingent upon her death. Under local law, as set forth in § 236, Part B, 1(a) of the New York Domestic Relations Law, the parties may designate by agreement which payments are maintenance payments and which payments are distributive awards of property.

[REDACTED], in opposition to the above stated arguments, asserts that all the statutory requirements under I.R.C. § 71(b)(1) are met. Therefore the payments, including the initial payment of \$[REDACTED] must be treated as alimony for federal tax purposes. He acknowledges that the initial payment of \$[REDACTED] is not terminable at the death of the payee spouse. Presumably, the fact that it was made upon entering the agreement somehow makes the terminability feature of I.R.C. § 71(b)(1)(D) irrelevant.

DISCUSSION

In the Tax Reform Act of 1984, I.R.C. § 71 was amended to delete the requirement that an alimony payment must be periodic and to delete the requirement that it be made on account of a marital obligation imposed under local law. Congress felt that differences in state law created differences in federal tax consequences and caused administrative difficulties for the

Internal Revenue Service. The revised definition of alimony was meant to make the definition more objective and to prevent the deduction of large, one-time lump-sum property settlements.

Under the revised definition of alimony, applicable to the year the above separation agreement was executed, I.R.C. § 71(b) provides, in simplified form, that a payment received by, or on behalf of, a spouse or former spouse under a divorce or separation instrument is alimony if all of the following requirements are met:

- (1) The payment is in cash.
- (2) The parties do not designate that the payment is not deductible by the payor and not includible by the payee as alimony.
- (3) If the parties are separated under a decree of divorce or separate maintenance, the parties are not members of the same household when the payment is made.
- (4) There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
- (5) The payment is not treated as child support.
- (6) Payments that exceed \$10,000 are to be made in each of the 6 post-separation years.

Issue 1

I.R.C. § 71(b)(1)(B) provides that a payment that otherwise satisfies the definition of alimony is alimony only if the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under section 71 and not allowable as a deduction under section 215.

Temporary Treas. Reg. § 1.71-1T(b), Q&A A-8, provides that the spouses may designate that payments otherwise qualifying as alimony or separate maintenance payments shall be nondeductible by the payor and excludible from gross income by the payee by so providing in a divorce or separation instrument.

Under I.R.C. § 71(b)(1)(B), spouses are given the option of providing in a divorce or separation instrument that payments otherwise qualifying as alimony need not be so treated for tax purposes. In order to exercise this option, the spouses must designate that the payments made under the agreement are not includible in income by the recipient spouse and not deductible by the payor spouse. This election is made by attaching a copy of the separation or divorce instrument designating the payments as such with the payee spouse's first income tax return for each year to which the election applies. The spouses can change the election from year to year.

In the instant case, we agree with [REDACTED] that language in the separation agreement designating the initial payment as part of the property settlement was not sufficient to effectuate the non-alimony election contained in I.R.C. § 71(b)(1)(B). The revisions to I.R.C. § 71(b) were meant to make the definition of alimony more objective. If we were to examine the intent of the parties with respect to whether they regarded the relevant payment as alimony for federal tax purposes, we would be opening the door to subjective criteria. We believe this would violate the spirit of the revisions to I.R.C. § 71(b). Accordingly, we construe the language in I.R.C. § 71(b) in accordance with its strict terms.

Issue 2

I.R.C. § 71(b)(1)(D) provides that a payment shall be treated as alimony only if there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

In order to prevent the deduction of amounts which are in effect transfers of property unrelated to the support needs of the recipient, the Tax Reform Act of 1984 provided that a payment qualifies as alimony only if the payor (or any person making a payment on behalf of the payor) has no liability to make any such payment for any period following the death of the payee spouse. See, e.g., Moore v. Commissioner, T.C. Memo. 1989-49. Originally, the Act required that the instrument, itself, state that there is no such liability. The Tax Reform Act of 1986 eliminated this requirement retroactively, permitting the requirement to be satisfied by operation of law.

If an oral agreement for termination of support payments is enforceable under local law or if another document provides for termination, I.R.C. § 71(b)(1)(D) is satisfied. Likewise, local law may provide that support payments are automatically terminated by operation of law upon the death of the recipient spouse. Under such circumstances, I.R.C. § 71(b)(1)(D) is also satisfied.

In the instant case, the separation agreement makes no mention regarding the terminability of the initial property settlement payment upon the death of [REDACTED]. In addition, payments designated as support by the instrument are given effect by the New York Domestic Relations law. Under such law, payments designated as part of the property settlement are not terminated by the death of the recipient spouse. Accordingly, we conclude that the initial payment of \$[REDACTED] in this case is neither terminable by operation of the instrument or by operation of local law. Under such circumstances, the initial payment fails

to satisfy the test of terminability contained in I.R.C. § 71(b)(1)(D) and therefore cannot be considered alimony.

The Attorney for [REDACTED] apparently believes there is an exception for initial payments. We see no reason for such exception. Rev. Rul. 72-133, 1972-1 C.B. 25, indicates that an initial payment may qualify as alimony provided such payment is subject to termination upon death of the former wife. The controlling question is whether the initial payment is, in fact, subject to termination upon the death of the payee spouse under the instrument or under local law.

You state in your memorandum that if the initial payment is not alimony, then none of the payments are alimony since there would only be five years of payments thereby not meeting the six-year rule of I.R.C. § 71(f) in effect at the time the separation agreement was entered.

I.R.C. § 71(f)(1), in effect at the time the separation agreement was entered, states that alimony or separate maintenance payments (in excess of \$10,000 during any calendar year) paid by the payor spouse to the payee spouse shall not be treated as alimony or separate maintenance payments unless such payments are to be made by the payor spouse to the payee spouse in each of the 6 post-separation years (not taking into account any termination contingent on the death of either spouse or the remarriage of the payee spouse).

Temporary Treas. Reg. § 1.71-1T(d), Q&A A-19, provides that there are two excess front-loading rules under I.R.C. § 71(f) which may apply to the extent that payments in any calendar year exceed \$10,000. The first rule is a minimum term rule, which must be met in order for any annual payment, to the extent in excess of \$10,000, to qualify as an alimony or separate maintenance payment. This rule requires that alimony or separate maintenance payments be called for, at a minimum, during the 6 post-separation years.

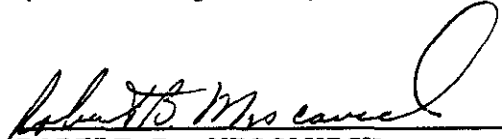
Temporary Treas. Reg. § 1.71-1T(d), Q&A A-23, answers how the minimum term rule operates. In an example provided therein, A is to make alimony payments to B of \$20,000 in each of the 5 calendar years 1985 through 1989. A is to make no payment in 1990. Under the minimum term rule, only \$10,000 will qualify as an alimony payment in each of the calendar years 1985 through 1989.

Based upon the above, [REDACTED] should include only \$ [REDACTED] of each support payment in income as alimony since only [REDACTED] payments of \$ [REDACTED] each are to be made under the separation agreement. The remaining installment of \$ [REDACTED] on each payment is not to be treated as alimony under I.R.C. § 71(f).

If you have any questions concerning the above issue, please contact William Baumer at FTS 566-3325.

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